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¶B. SANAA 2005 1976
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Classified By: DCM Nabeel Khoury for reasons 1.4 (b) and (d).

¶1. (C) SUMMARY: On March 20, the International Monetary Fund (IMF) completed its Article IV Consultation for Yemen. In a briefing for donors, the Fund's macroeconomic projections were decidedly bleak, emphasizing an impending fiscal crisis caused by declining oil reserves and increased spending. This analysis largely confirms existing studies, and will mean a series of tough choices for the ROYG in the next five years. The IMF's remedy includes cutting subsidies, reducing the civil service, new taxes and partially devaluing the currency, all likely to bring a period of instability. There is some indication that the IMF may be willing to become more engaged with the ROYG in implementing these reforms. The Fund's representatives also diverged from the usual script to support donor reform objectives to improve governance and the investment climate. END SUMMARY.

"One of the Toughest Outlooks I've Ever Seen"

¶2. (U) A delegation of the International Monetary Fund recently completed its 2005 Article IV Consultation on Yemen's macroeconomic health. The report will likely be published at the end of May. On March 20, USAID Director and Econoff attended a donor meeting at which the IMF offered a summary of their findings.

¶3. (C) Lorenzo Perez, Deputy Director for the Middle East and Central Asia, estimated steady GDP growth of four percent for 2005, with 4.5 percent non-petroleum growth. The overall macroeconomic picture presented by the IMF, however, was very negative. According to Perez, the combination of three percent population growth and declining oil reserves will place enormous pressure on the budget in the near future. Privately, Perez told Econoff: "Yemen's outlook is one of the toughest I've ever seen." (NOTE: 80 percent of annual revenues in Yemen are derived from oil sales. END NOTE.)

Declining Oil Will Bring Fiscal Crisis

¶4. (U) Declining oil production will dominate this year's report, warned Perez. After collecting data from both the ROYG and private companies, the IMF predicts a drop in

production from 390,000 barrels per day to 260,000 within five years. Without a major new discovery, Yemen may run out of oil reserves by 2016. The ROYG is currently tendering a number of new blocks for exploration, but most experts predict additional production of only 20-30,000 barrels per day. Liquid natural gas exports are expected to begin in 2009, generating USD 1 billion a year, but even this will not significantly offset declines in oil. (Septel) These negative trends will ultimately put pressure on Yemen's foreign currency reserves, which recently exceeded USD 6 billion.

¶5. (SBU) The IMF warned that the ROYG's budgeting practices were dangerously expansionary. In a year of record high oil prices, Yemen is expected to show a deficit of three percent of GDP in its 2006 budget. With declining oil revenues, this could increase to a deficit of 20 percent by 2010. Yemen routinely underestimates oil revenues (this year it projects prices at USD 40 per barrel), requiring supplementary budgets to allocate additional funds. (Ref A) According to the IMF, however, this revenue is likely to be largely consumed by fuel subsidies. Despite a significant reduction in the subsidy last July, rising oil prices have largely negated these gains, with the cost for this year's subsidy running at approximately USD 800 million (more than five percent of GDP).

An Eye on Inflation

¶6. (U) Maintaining a stable exchange remains the Central Bank's highest priority, said IMF representatives. Currently trading at 196 YR to the dollar, the riyal has lost less than five percent of its value against the dollar over the past year. The ROYG regularly intervenes to bolster the riyal, most recently in January, when it pumped USD 215 million from foreign currency reserves into the local market.

¶7. (U) The Fund is more concerned with inflation, however, which has fluctuated between 10 and 13 percent in recent years. Some contacts at the Central Bank predict that overall inflation for 2005 will be closer to 20 percent, but this includes a one-time inflationary spike caused by the partial lifting of oil subsidies. (Ref B) Nevertheless, the IMF predicts a steady increase in inflation rates, due largely to high oil prices. Ultimately, Perez said the ROYG must allow for a more flexible exchange rate, which would likely result in a significant devaluation of the riyal. (NOTE: This would be a serious blow to average Yemenis, who are largely dependent on import commodities. END NOTE.)

Fund Offers Bitter Medicine

¶8. (U) The Article IV report will note several positive developments in the ROYG's efforts to increase revenue. The long-delayed value-added tax is expected to go into full effect by January 2007. (Ref C) Combined with more effective methods of tax collection and customs fees, this could generate as much as three percent of GDP in new revenues. Perez also warned that the ROYG must restrain growth in the wage bill, which doubled the minimum wage this year. Despite low salaries for civil servants, the IMF contends that the ROYG simply cannot afford a spending increase of this size. If implemented, civil service reform could also reduce expenditures. The ROYG claims it will issue biometric cards to government employees within two months, in order to cut down on "ghost workers" and those drawing more than one salary. Perez also suggested that the rising defense budget, approximately seven percent of GDP, was high for the region.

¶9. (SBU) All of these reforms combined, however, would not have the same impact as eliminating fuel subsidies, which amount to nine percent of GDP. Perez recognized that

removing subsidies is painful for average citizens, as evidenced by last July's riots, and recommended a more gradual approach. (Ref B) Fuel prices could be adjusted to international prices over a period of three years, said Perez. Without such measures, said Perez, not only will Yemen face declining revenues, but debt levels (mainly domestic) will also become unsustainable, perhaps rising to 100 percent of GDP within five years. This would almost certainly cause a crisis of confidence in Yemen's economy, leading to a currency collapse and capital flight.

IMF Joins Call For Governance Reforms

¶10. (SBU) The Article IV delegation diverged this year from strict monetary policy to address broader issues affecting Yemen's investment climate. These issues are more difficult to address from a macroeconomic standpoint, as there are few available statistics for unemployment, poverty levels and other key measures of standard of living. Perez stressed that the IMF was committed to pro-growth policies, and noted problems in the banking sector, accounting standards and rule of law as impediments to investment. In general, Perez expressed strong support for the donors' coordinated approach to governance reform, and stressed the importance of such measures for Yemen's business climate. (Ref D) "Ultimately," said Perez, "Yemen must clean up its own house." (NOTE: This defense of the Fund's pro-growth position was a direct response to the UN, which has charged that the IMF does not sufficiently emphasize job creation and poverty reduction in Yemen. END NOTE.)

¶11. (C) The team was somewhat encouraged by the new Minister of Finance, Seif Al-Asali, and his outspoken commitment to reform. (Ref E) Asali recently replaced the Ministry's budget director and is reportedly eager to replace a large number of middle managers who have become complacent or corrupt. Perez was cautious about a number of Asali's specific initiatives, however, describing him as "a man in a hurry." Some of Asali's more dubious priorities include setting up a stock market and reducing the corporate tax, which stands at a relatively high 35 percent. IMF analysts were concerned that despite the potential of a tax cut to stimulate growth, it could deprive the ROYG of critical revenue when it needs it most. The IMF was willing to contemplate such a move only if accompanied by the elimination of some of Yemen's multiple tax exemptions.

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Comment: Desperate Times Call For Enhanced IMF Role
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¶12. (C) This year's Article IV Consultation does not come as a shock to close observers of Yemen's economy, and confirms many of the more dire predictions of the World Bank and others. Declining oil reserves lie at the heart of the problem, and replacement revenues cannot be found without major changes in Yemen's economic and fiscal policies. IMF representatives do not expect any of these difficult decisions to be made before the September elections, but they hope to engage the ROYG immediately thereafter with another visit in October. The IMF currently has no presence in Yemen and essentially cut its program in 2001 when reforms stalled. The Fund said it cannot return in force without an invitation from the ROYG, but some in the donor community feel that the time is ripe for full engagement. Many of the IMF's recommended macroeconomic reforms will likely bring serious instability, and require the Fund's expert guidance to be implemented effectively.
Krajeski